# FIXED INCOME STRATEGY HIGHLIGHTS… APRIL, 2010

*Written By:* *Peter J. Altman, President*
*Jeffrey S. Baumann, Managing Director*
*Karen Troiano, Senior Portfolio Manager*

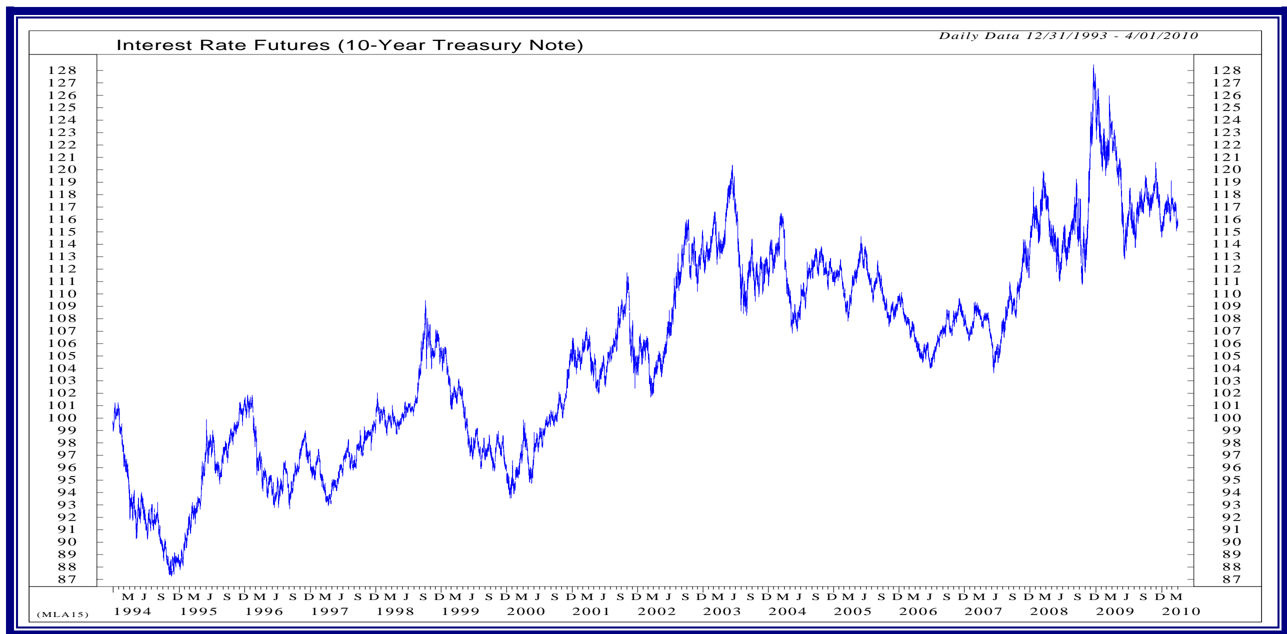
Altman Investment Management
34 Chambers Street
Princeton, NJ 08542
609.252.0048
paltman@altman-investment.com

## THE U. S. FIXED INCOME MARKETS

### MARKET OVERVIEW

After the stunning turnaround from crisis to normalization, bond markets are lately contending with a modest bout of risk aversion. The strong momentum fueled by resurgent risk appetites that carried into the New Year – characterized by sharp spread compression and rising benchmark yields – has slowed and, in some areas, reversed course. The shift has been triggered by the usual suspects: heightened government fiscal concerns, hostile political rhetoric and cyclical uncertainties. Plus, China unexpectedly started tightening the reins on bank lending activity in January, which naturally has implications on global growth. The overall U.S. bond market, as measured by the Merrill Lynch 1-10 year Domestic Master Index returned 1.69% for the quarter ending. The first quarter presented a moderate divergence in sector performance with U.S. governments returning 1.1%, mortgages returning 2.02% and corporates returning 2.86%.

**EXHIBIT I**




*Source: Ned Davis Research*

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.

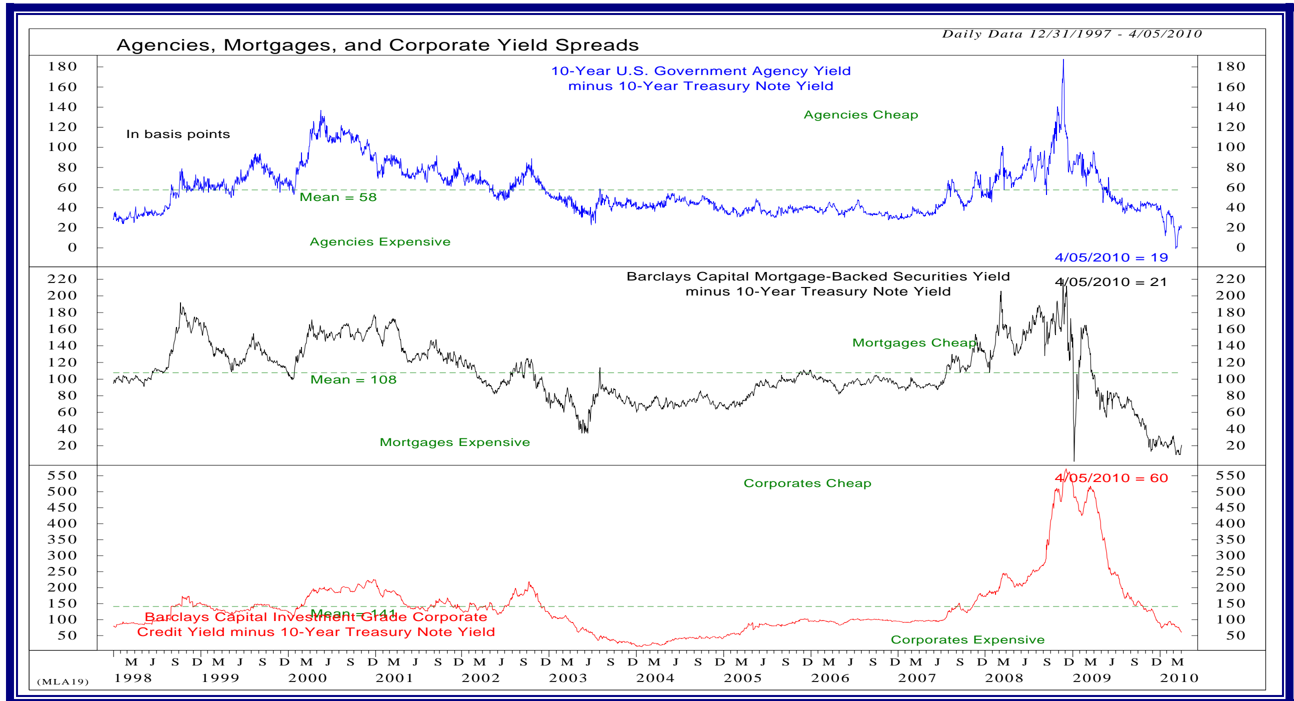
Recent developments portend less about a fundamental shift than a confirmation that the healing process is not yet over. And that the investment climate has become more challenging. This may be sobering to consider after the double-digit returns produced by spread markets in 2009. But we reluctantly concede that this appears par for the course. Investors should keep in mind that economies are still clawing their way back from the most severe downturn since the Great Depression.

Elevated uncertainties are also bound to persist given the overlay of proposed secular changes this time around. This complicates attempts to gauge growth prospects – namely, discussions related to a new regulatory scheme, which will critically affect the potential pool of credit. It's going to be a rocky road but, as we all know, the path from catastrophe to smooth sailing is rarely linear.

Perhaps most importantly, capital markets appear healthy enough to function largely without government intervention. For example, normalized spread relationships in interbank lending markets and asset-backed (ABS) securities should be comforting. If you recall, spreads in the former only improved *after* central banks jump-started liquidity with additional financing facilities last year. ABS prices only improved *after* TALF (Term Asset-Backed Securities Loan Facility) was introduced by the Fed and the ECB announced that it would finance purchases. Recent market activity suggests that the gradual withdrawal of ABS support measures is likely to cause only a modest impact on spreads in the US but may be more challenging in Europe. Indeed, high cash participation in TALF auctions during the last few months suggests that the impact of government financing has already been marginalized.

It is our expectation that the elimination of official support measures should proceed fairly smoothly and produce only modest spread widening as markets adjust (for example, around 25bps to 75bps in agency MBS). Nonetheless, the impact of official exit strategies will vary and, frankly, is difficult to accurately gauge given that these extraordinary steps were not part of the revival process in past downturns.

**EXHIBIT II**



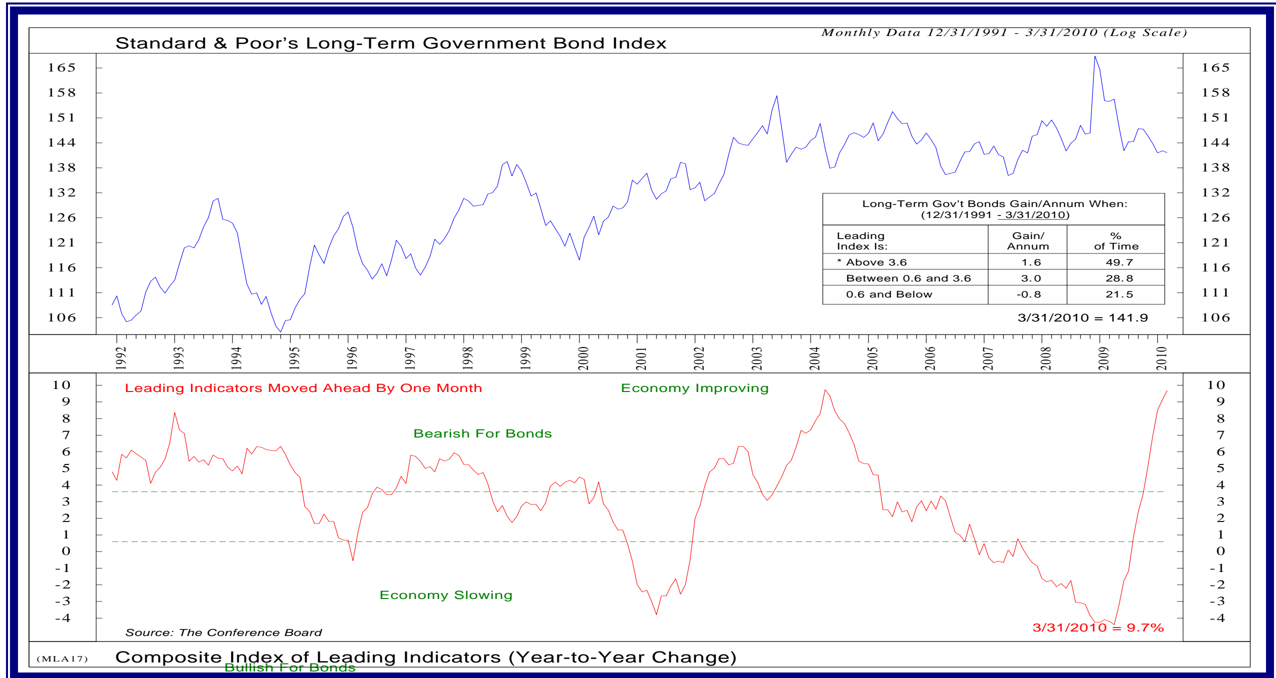

*Source: Ned Davis Research*

## GOVERNMENT RELATED DEBT

Although spreads currently trade near long-term norms, even modest widening is likely to generate outperformance compared to risk-free debt. US government-sponsored enterprise (GSE) step-up coupon structures currently offer the best value. These structures diversify portfolios and are a defensive hedge against rising interest rates. Short callable GSE debt also is attractive relative to certificates of deposit. In non-callables (bullets), supranational debt (e.g., KFW, EIB) provide yield pick-up relative to US agency debt.

Spreads on current coupon agency pass-through MBS are near historic lows. Although spreads should be well-supported in the near term, current valuations are not compelling, in our view. As opposed to pass-throughs, Ginnie Mae CMOs are attractive since investors can purchase this government-backed debt with higher yields and protection against extension risks, in some structures. In ABS, investors should focus on lower quality to identify relative value, particularly amongst the BBB-rated credit card and retail auto issues, which compare favorably to unsecured corporate debt.

**EXHIBIT III**




*Source: Ned Davis Research*

## HIGH GRADE CORPORATES AND PREFERREDS

We maintain a bullish view on credit and expect the recent spread widening to eventually reverse. That said, spread narrowing is apt to be modest, at best. Interest returns should help to lead outperformance in credit versus other investment grade sectors, in our view. We are considering the highest quality subordinated bank and finance debt, where spreads are still wide versus their senior unsecured counterparts. We also favor the metals and mining sector, where emerging market demand fueled by stimulus measures is supporting stronger fundamentals. Steep credit curves continue to offer investors opportunities to add some duration as interest rates climb through out this year.

Value still exists in the capital trust preferred arena, consistent with our positive conviction on subordinated bank debt. We favor preferred issues with high liquidity amongst the largest bank/finance/insurance names. We recommend capital trust preferreds of US-based issuers compared to the UK and other Euro-area financial institutions. The best opportunities continue to be reflected in the primary market, which currently trades cheap compared to secondary issues.

**EXHIBIT IV**

| | | 12/31/2009 | 9/30/2009 | 03/31/2009 |
|---|---|---|---|---|
| | | | | |
| 10 Year Muni * | | 3.96% | 3.24% | 3.61% |
| 10 Year Treasury | | 3.83% | 3.53% | 3.83% |
| | | | | |
| Ratio | | 103% | 92% | 94% |

*Source: Bloomberg and Altman Investment Management, LLC*
** Merrill Lynch Global Index- Investment Grade*

* The impact of an upward shift in the yield curve on long duration instruments suggests that positive performance will likely be led by return on the cost of borrowing, not the price of the issue.

## MUNICIPAL BONDS

Rising benchmark rates and a more limited supply of traditional tax-exempt paper due to the increase in taxable debt (Build America Bond, or BAB) supply will likely keep municipal yield ratios near historic lows relative to Treasuries. Currently municipal bonds appear fairly rich relative to long-term norms (particularly longer-dated paper). Additionally, widely deteriorating budgets provide little hope that fundamentals will improve near-term. Tax-exempt investors should focus on Single-A maturities in the 5-year to 10-year range and essential service revenue bonds. Investors should also diversify portfolios with out-of-state securities where feasible. BABs (Build America Bonds) offer attractive value compared to similarly rated non financial corporate debt

**EXHIBIT V**

*Source: Bloomberg and Altman Investment Management Research*

***Monetary Policy Implications***

The current level of short-term interest rates reflects an emergency response to a crisis situation. The crisis appears to have since receded, leading some to argue it is time to embark on the long road back to a more normal stance. Tightening sooner rather than later would minimize the risk of making an inflationary mistake, and in the process potentially strengthen central bank credibility. Those that support this view believe that a rise of 25 to 50 basis points in rates between now and the end of the year would still represent an accommodative fed funds rate at 50 to 75 basis points, and be highly stimulative from any historical perspective.

A modest rise in interest rates would probably not do much economic or financial damage in itself, however it does not address the reality of the trauma the Fed and other central banks just went through. The speed and viciousness of the economic and financial collapse, in retrospect, were completely misunderstood and their various models proved to be ineffective in predicting both the downturn and the spread of financial contagion. This has left policy makers very cautious with respect to supporting a policy that rigidly interprets monetary policy and inflation targeting and recognizes that important changes in policy initiatives can have a significant impact on pubic expectations and current economic behavior. Although economists like Robert Lucas, Jr (the 1995 Nobel Prize winner) argued that it is doubtful that policy makers can control the economy with any degree of precision it would appear that policy makers today would rather err on being a bit too late in tightening as a much smaller mistake than tightening before there is certainty that the economic recovery is on a self-sustaining path. (1.)

(1). Inflation Targeting: Lessons from the International Experience; Princeton University Press, Ben S. Bernanke, Laubach, Mishkin, & Posen: copyright 1999.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.